Chapter 15
Real Estate Financing: Practice

OUTLINE:

I. Introduction to the Real Estate Financing Market
   A. Federal Reserve System
      1. Created to help maintain sound credit conditions
      2. Helps counteract inflationary and deflationary trends
      3. Attempts to create a favorable economic climate
      4. Divides country into 12 federal reserve districts
      5. Regulates the flow of money and interest rates
         a. Controls bank reserve requirements
            (1) Funds unavailable for loans or any other use
            (2) Designed primarily to protect customer deposits
            (3) Also provides a means of manipulating the flow of cash into the
                 money market
         b. Controls bank discount rates
            (1) When banks borrow from their district reserve banks, their loan
                interest rate determines what interest rate they must charge their
                borrowers.
            (2) A high discount rate reduces consumer borrowing; a low
                discount rate stimulates consumer borrowing.

II. The Primary Mortgage Market
   A. Lenders provide funds to borrowers as investments
      1. Income generated for lender from
         a. Finance charges-loan origination fees and discount points
         b. Recurring income-interest
      2. Selling loans in secondary mortgage market
         a. Generate funds to make new loans
         b. Servicing loans—collecting payments, accounting, bookkeeping,
            processing payments of taxes and insurance, and following up on
            delinquencies
   B. Thrifts, savings associations and commercial banks
      1. Fiduciary lenders
      2. Subject to regulations set by government agencies such as
         a. Federal Deposit Insurance Corporation (FDIC)
         b. Office of Thrift Supervision (OTS)
   C. Insurance companies
      1. Invest much of their premium income in profitable enterprises, such as long-term
         real estate loans
      2. Prefer income-producing commercial and industrial properties
3. Invest in residential loans by purchasing large blocks of government backed
    loans from the Fannie Mae and other mortgage warehousing agencies

D. Credit unions
   1. Cooperative organizations that require membership to borrow
   2. Only recently started making long-term first and second mortgage loans

E. Pension funds
   1. Only recently started making long-term first and second mortgage loans
   2. Funds channeled through mortgage bankers and mortgage brokers

F. Endowment funds
   1. Commercial banks and mortgage bankers handle
   2. Source for financing low-risk commercial and industrial property

G. Investment group financing
   1. Very popular for large real estate projects
   2. Funds come from such sources as partnerships and investment trusts.

H. Mortgage banking companies
   1. originate real estate loans using funds borrowed from others as well as their own
      funds.
   2. often serve as intermediaries between investors and borrowers, but not as
      mortgage brokers.
   3. generally service the loan once it has been made.
   4. are usually organized as stock corporations.
   5. are usually subject to fewer restrictions than other lenders.

I. Mortgage brokers
   1. act as intermediaries between borrowers and lenders.
   2. locate borrowers, process their loan applications, and submit them to lenders.
   3. do not service the loan once it has been made.
   4. consult state’s laws regarding licensure or registration of mortgage brokers.

III. The Secondary Mortgage Market

A. Secondary mortgage market—where loans are bought and sold after they have been
   funded

B. The originating lender may service the loan for a fee.

C. Agencies: Purchase real estate loans and then assemble them into securities for sale to
   investors.

D. Fannie Mae
   1. A quasi-governmental agency—a privately-owned stock-issuing corporation
      supervised by the federal government
   2. Deals in all real estate loans—FHA, VA, and conventional
3. Buys block or pool of mortgages from a lender in exchange for mortgage-backed securities

E. Ginnie Mae

1. Exists as a division of HUD
2. Administers special assistance programs for real estate loans
3. Works with Fannie Mae in the secondary mortgage market
4. Joins with Fannie Mae to provide "tandem plan" funds in times of high interest rates and tight money
5. Issues the Ginnie Mae pass-through certificates
   a. A security interest in a pool of mortgages
   b. It "passes through" the principal and interest payments directly to the holder of the certificate.
   c. The payments are guaranteed by Ginnie Mae.

F. Freddie Mac

1. Provides a secondary market primarily for conventional loans
2. Sells mortgage-backed securities like Fannie Mae
3. Unlike Ginnie Mae, does not guarantee any payments

G. In Practice: Lenders use Fannie Mae/Freddie Mac standardized forms and follow their guidelines for underwriting procedures for loans they wish to sell them in the secondary mortgage market.

IV. Financing Techniques—although the term "mortgage" is used throughout this chapter, the provisions also apply to deed of trust loans

A. Straight loans

1. Also called "term loans" or "nonamortizing loans"
2. Periodic payments of interest only with the entire principal balance due at the end of the loan term
3. Generally used for home improvement and second mortgages

B. Amortized loans

1. Also called "direct reduction" loan
2. Level-payment mortgages
   a. Each payment is the same dollar amount.
   b. The amount applied to the interest decreases with each payment.
   c. The amount applied to the principal increases with each payment.
3. Regular periodic payments are made, with each payment being applied first to the interest owed and the balance to the principal amount.
4. By the end, of the term all the principal has been paid off gradually.
5. Most amortized loans paid in monthly installments; some paid quarterly or semiannually
6. Math Concepts: The mortgage amortization triangle

C. Adjustable-rate mortgages (ARMs)

1. Interest rates fluctuate, and therefore, so do the payments.
2. Components include
   a. interest rate tied to the movement of an index.
b. interest rate equals the index rate plus a premium, the margin—the lender's profit and cost of doing business.

c. rate caps that limit the amount the rate can increase both periodically and over the life of the loan.

d. payment cap that sets the maximum payment amount (might cause negative amortization).

e. adjustment period that sets how often the rate can be changed.

D. Balloon payment loans

1. The periodic payments are not sufficient to fully repay the principal loan balance by the end of the term of the loan.
2. Characteristic of a partially amortized loan
3. Math Concepts: Balloon payment loan

E. Growing-equity mortgages (GEMs)

1. Known as a rapid-payoff mortgage
2. Increase in payments during the term of the loan reduces the principal amount more rapidly.
3. Borrower's equity grows faster than normal.

F. Reverse-annuity mortgages (RAMs)

1. Regular monthly payments made to the borrower
2. The accrued debt (principal and interest) becomes payable at some specified future event, such as the sale of the property or by the estate upon the death of the owner.

V. Loan Programs

A. Loans are classified based on the loan-to-value ratio

1. Value based on the sale price or appraisal, whichever is lower
2. Lower the ratio of debt to value, the higher the down payment; a more secure loan, minimizes lender’s risk
3. Math Concept: Determining LTV

B. Conventional loans

1. Loan-to-value ratio lowest; borrower makes significant down payment
2. Security for the loan is provided solely by the mortgage.
3. Payment of debt rests solely on the ability of the borrower to pay based on the borrower's
   a. creditworthiness as indicated by credit reports.
   b. amount of income.
   c. amount of existing outstanding debt.
4. Consult lenders for current LTV and borrower ratios.

C. Private mortgage insurance

1. Loan-to-value ratio is higher than for other conventional loans.
2. Additional security for the loan for the lender is provided by private mortgage insurance.
3. 25 to 30 percent of the loan is insured.
4. Borrower pays insurance premiums.
5. Consult lenders for current rates.
6. PMI is to drop automatically when loan-to-value is 22%.

D. FHA-insured loans

1. FHA — part of the Department of Housing and Urban Development (HUD)
2. FHA insures real estate loans made by approved lending institutions.
3. Most common program: Title II, Section 203(b)
   a. For one-to-four-family residences
   b. Borrower or someone else pays mortgage insurance premium (MIP) in cash or it may be financed.
   c. FHA sets standards for the type and construction of buildings and neighborhood and qualifications for borrowers.
   d. The property must be appraised by an FHA-approved appraiser.
   e. FHA sets maximum loan amounts.
   f. Consult local lenders for current loan requirements.
4. Other FHA loan programs— for home improvement purposes, for condominium units, and adjustable rate mortgage loans
5. Prepayment privileges— no penalty to prepay (loans made prior to August 2, 1985 require minimum 30 days’ advance notice)
6. Assumption rules— depends on when loan was originated
   a. Loans before December 1986— generally no restrictions
   b. Loans between December 1, 1986 and December 15, 1989— buyer must submit to a creditworthiness review
   c. Loans on and after December 15, 1989— no assumptions without complete buyer qualification
7. Discount points— who pays them and in what amount is negotiable between the parties; concessions exceeding 6 percent of the sales price will trigger a reduction in the property’s sales price.

E. VA-guaranteed loans

1. The Department of Veterans Affairs (VA)
   a. Authorizes the guarantee of home loans for eligible veterans
   b. Sets the minimum service times of 90 days, 181 days or two years, depending on the calendar dates of service
   c. Reservists who do not otherwise qualify are also eligible.
2. VA guarantees real estate loans made by approved lending institutions.
3. Financing provisions
   a. Generally, no down payment is required.
   b. There is no limit on the amount of the loan; determined by lender.
   c. Limit on the maximum amount of VA guarantee
      (1) Maximum guarantee amount is $60,000.
      (2) Generally lenders will loan up to four times the veteran's available guarantee amount, or $240,000 maximum.
   d. The veteran must apply for a certificate of eligibility that indicates the maximum guarantee to which the veteran is entitled.
   e. The VA will issue a certificate of reasonable value (the VA approved appraisal)
      (1) to indicate the property's maximum value for guarantee purposes.
      (2) If property appraises for less than the sales price, veteran can make a down payment in cash to make up the difference between the appraisal and sale price.
4. Fees:
   a. Loan origination fee paid to lender
   b. Funding fee paid to VA
   c. Discount points—can be paid by the veteran, seller, or other person
5. Prepayment privileges—can prepay without any penalty
6. Assumption rules
   a. For VA loans made after March 1, 1988, the VA must approve the buyer and assumption agreement.
   b. Processing fee is usually $500.
   c. Original borrower remains liable for the loan unless VA approves a release of liability; lender must release separately.
   d. Non-veterans may assume the loan.

F. Farm Service Agency (FSA)
   1. Formerly the Farmers Home Administration, a division of the Department of Agriculture
   2. Provides loans to help purchase or improve properties in rural areas, primarily farms and single-family residences
   3. Has guaranteed loan programs as well as a direct loan program
   4. Loans to low/moderate income families at low interest rates

VI. Other Financing Techniques
A. Purchase-money mortgages
   1. Can refer to any type of real estate financing for the purchase
   2. Often refers to an extension of credit by the seller to the buyer that enables the buyer to purchase the property; the seller “takes back” a note for some or all of the purchase price

B. Package loans
   1. One loan covering both real and personal property
   2. Usually used in new home sales to include the financing for floor and window coverings, major appliances, and other similar items of personal property

C. Blanket loans
   1. are one loan secured by multiple parcels of property as collateral.
   2. are usually used in the financing of subdivision developments.
   3. have a partial release clause that enables borrower to get a release of one of the parcels while the lien remains in place on the other parcels.

D. Wraparound loans
   1. allow the new lender to assume responsibility for the payment of the existing loan (the underlying obligation) and give the borrower a new increased loan at a higher interest rate.
   2. may be prevented by an acceleration and alienation or due-on-sale clause in the original mortgage.

E. Open-end loans
   1. secure a note for a current loan and for any future advances.
   2. allow a borrower to “open” the loan to increase the debt to its original amount.
F. Construction loans
   1. Periodic payments often called "draws"
   2. Made to the general contractor at predetermined progress points
   3. Paid off and replaced by a permanent or "take out" loan

G. Sales and leasebacks
   1. The seller sells the property and leases it back, receiving cash and the use of the property; becomes the lessee.
   2. The buyer receives the income from the rent and an ideal tenant; becomes the lessor.
   3. Transactions usually require expert legal and tax advice.

H. Buydowns
   1. Some of the buyer's future interest paid in advance to the lender by the seller or some other individual.
   2. Used frequently by home builders as an incentive to buyers

I. Home equity loans
   1. Usually junior to the loan obtained to purchase the property
   2. Can be an equity line of credit or a fixed amount

VII. Financing Legislation

A. Truth-in-Lending Act and Regulation Z
   1. Requires lenders to disclose to borrowers the true cost of obtaining credit so that interest rates among lenders can be compared
   2. Applies to all loans of $25,000 or less for private consumers
   3. Always applies when a residence collateralizes the loan
   4. Does not apply to agricultural loans or business or commercial loans over $25,000
   5. The consumer must be fully informed of all financing charges, including loan origination fees, finders' fees, service charges, discount points, and interest charges.
   6. The lender must compute and disclose the annual percentage rate (APR)—the true cost of the financing to be obtained.
   7. For purposes of Regulation Z, a creditor is defined as one who
      a. Extends consumer credit more than 25 times a year or more than 5 times a year if the transaction involves a dwelling as security.
      b. Subjects the credit to a finance charge or contracts for payments in more than four installments.
   8. Three-day right of rescission
      a. Applies to most Regulation Z consumer credit transactions.
      b. Does not apply to residential purchase money or first mortgage or deed of trust loans
   9. Advertising for real estate financing
      a. Must give the annual percentage rate
      b. APR must include the total finance charges
      c. If any specific loan terms (trigger terms) are mentioned, all terms must be included such as the cash price; required down payment; number, amounts, and due dates of all payments; and the annual percentage rate
10. Penalties for noncompliance include
   a. liability to the consumer for twice the amount of the finance charge with a
      $100 minimum and a $1,000 maximum.
   b. court costs, attorneys’ fees and actual damages.
   c. fines of up to $10,000 for each day a violation continues after an
      administrative order enforcing Regulation Z is given or for engaging in
      unfair or deceptive credit practices.
   d. for willful violations, up to a $5,000 fine or one year in prison or both.

B. Equal Credit Opportunity Act (ECOA)
   1. Prohibits lenders and those who grant or arrange credit to consumers from
      discriminating on the basis of
      a. race,
      b. color,
      c. religion,
      d. national origin,
      e. sex,
      f. marital status,
      g. age (provided the applicant is of legal age), or
      h. dependence on public assistance (welfare).
   2. Lenders and creditors must inform rejected credit applicants, in writing within 30
      days, why credit was denied or terminated.

C. Community Reinvestment Act of 1977 (CRA)
   1. Financial institutions are expected to meet deposit and credit needs of
      community, participate in development and rehabilitation projects and loan
      programs.
   2. Law requires statement by lender
      a. defining geographic boundaries of community,
      b. identifying type of community reinvestment credit offered, and
      c. including comments from the public about lender’s performance in
         meeting community needs.

D. Real Estate Settlement Procedures Act (RESPA)—created to provide the parties to a
   residential real estate transaction involving new financing with disclosure of all settlement
   charges (see Chapter 22)

E. Computerized loan origination (CLO) and automated underwriting
   1. An electronic network for handling loan applications that provides lists of
      mortgage lenders, rates, and terms
   2. Real estate agent may assist buyer in selection of lender and applying for loan
      on-screen.
   3. Broker may earn fees up to 1/2 point of loan amount; borrower must pay fee.
   4. Automated underwriting procedures shorten loan approval times,
      a. lower cost of application,
      b. reduce lenders’ time on approval process, and
      c. strengthen buyer’s offer to purchase by including proof of loan approval.
   5. Fannie Mae system called “Desktop Underwriter”; Freddie Mac system called
      “Loan Prospector”